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SUBJECT: INDONESIA - KOREAN INVESTMENT DISPUTE HIGHLIGHTS LABOR PROBLEMS

¶1. (SBU) Summary: An early October decision by apparel and shoe retailer Adidas to terminate supply contracts with three local shoe manufacturers has led to the layoff of 17,000 workers and sparked labor demonstrations. The three firms owe a combined \$140 million to Indonesian banks, but have not produced shoes for months. The Korean owners of two of the factories fled Indonesia without paying millions of dollars in required severance pay to workers, and show no signs of returning. The continuing closure of the three factories highlights both the disincentives in Indonesia's overly rigid severance pay system as well as weaknesses in Indonesia's bankruptcy system. End Summary.

Adidas Review Uncovers Supplier Problems

¶2. (U) Paul Griffiths, Chief Representative of Adidas Indonesia, briefed us in late December about recent financial woes affecting three Adidas suppliers in the Jakarta area. Adidas completed its buyout of Reebok in June 2006 during which Adidas reviewed Reebok's development and manufacturing contracts in Indonesia. In the course of the review, three factories caused concern: Korean-owned sister companies Dongjo and Spotek, and Indonesian-owned Tongyang.

¶3. (SBU) According to Griffiths, Dongjo and Spotek owed at least \$40 million to Indonesian banks but had few assets. A prominent South Korean businessman, Cheon Song Ho, owned a controlling 80% stake in the two firms, but subsequently reduced his ownership stake to a minority holding over the summer of 2006 and left for Korea. Ho has not been back to Indonesia since. Dongjo's new chairman, made several trips to South Korea in an attempt to raise capital, but did not return to Indonesia after his last trip in September 2006.

¶4. (U) Griffiths said Adidas lent Dongjo funds for materials purchases for future deliveries, but with \$15 million in debt to two suppliers and \$40 million in Bank debt, the company could not keep up the quality or quantity of the orders. Adidas terminated support in late September and the Dongjo factory closed October 13. Sister factory Spotek was not able to remain open or receive loans from Adidas due to the much smaller size of its orders and closed one week after Dongjo. The Indonesian-owned Tongyang factory closed on October 30 under the burden of \$100 million dollars in debt, although owner Danny Susanto is actively seeking buyers.

Workers Protest; Liabilities Mount

¶5. (SBU) The factory closings left 17,000 workers jobless with little explanation about why their factories closed. Factory managers repeatedly promised to reopen the factories and pay

financial compensation, but were unable to keep their promises. As a result, all three factories experienced labor unrest, with Spotek experiencing large demonstrations. The workers are also waiting for their severance payments, which represent approximately \$17 million in liabilities for the three factories on top of their already heavy debt burden. According to Griffiths, all three factories are capable of running at optimal capacity and once again supplying Adidas. However, all three are currently in legal limbo, with the Dongjo and Spotec factories declaring bankruptcy in late December. However, Indonesia's bankruptcy laws are slow-moving and complex, and it is unclear whether a new buyer would have to assume the large severance payouts, making the factories significantly less attractive. According to factory management, the Tongyang factory is set to re-open in April 2007, but it has not presented a financial plan that would permit it to reopen.

¶6. (SBU) Adidas remains very involved in the labor situation at the three plants, although the company does not have an equity stake in any of them. Adidas frequently consults with management, unions, and government officials. Earlier this month, Adidas was able to persuade Jamsostek, the Government social security fund, to release retirement payments to workers ahead of their actual retirements. Adidas is also funding six months of healthcare costs for workers. In addition, Adidas consulted with Minister of Trade Mari Pangestu, who supported the idea of talking to South Korea about the return of the Dongjo executives who fled Indonesia. However, Griffiths expressed doubt about pursuing Ho as he is widely believed to have close ties to the current South Korean administration.

¶7. (SBU) Comment: The investment dispute demonstrates the perverse incentives of Indonesia's current severance pay system. Very generous severance pay entitlements make workers reluctant to quit and move on to new jobs. At the same time, heavy severance pay costs can make fleeing the country a more attractive option than paying workers what they are due. The disputes also highlight a

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point that Indonesian and international business have been making for years--Indonesia's current severance pay system erodes the country's competitive advantage in labor intensive industries at the same time regional players present an increasingly attractive market. Nonetheless, the Yudhoyono Administration has shown very little inclination to move forward with politically difficult labor reforms after last April's labor demonstrations. More positively, although the three factory closings cost Adidas millions of dollars, Griffiths said the company remains positive about Indonesia and that production by Adidas contractors grew 26% over the past year, facts he attributed to high quality workmanship and well established supplier relationships. The challenge for Indonesia will be maintaining its market position in labor intensive industries as other Southeast Asian markets, especially Vietnam, are becoming increasingly more attractive due to more favorable labor and investment laws.

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